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# REFORMING THE REGULATION OF FANNIE MAE AND FREDDIE MAC

## Statement of Richard S. Carnell

**Before the Subcommittee on Capital Markets,**
**Insurance, and Government Sponsored Enterprises**
**Committee on Financial Services**
**U.S. House of Representatives**

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# SUMMARY


### *Choice of Regulator*

I support moving safety-and-soundness regulation of Fannie Mae and Freddie Mac out of the Department of Housing and Urban Development. HUD lacks both the will and the institutional credibility to stand up to the government-sponsored enterprises ("GSEs ). Having such regulation in HUD encourages White House personnel officials to regard the top regulator's job as primarily involving housing rather than safety and soundness.

But having the Federal Reserve Board regulate Fannie and Freddie could: conflict with the Fed's responsibility for monetary policy and the Fed's role as lender of last resort through the "discount window ; rely on an agency institutionally ill-suited to confront Fannie and Freddie; and create a potentially unhealthy concentration of power without adequate accountability. I recommend retaining the Office of Federal Housing Enterprise Oversight ("OFHEO ) as Fannie and Freddie's safety-and-soundness regulator, and making OFHEO an autonomous bureau of the Treasury Department.

### *Registration and Reporting Under the Securities Laws*

The bill would rightly repeal Fannie and Freddie's exemption from the registration and reporting requirements of the federal securities laws. This anachronistic exemption sends exactly the wrong signal: that the two firms are so "special, so close to the government, that investors in their securities have no need for the protections afforded by the registration and reporting requirements.

### *Correcting Defects in GSE Safety-and-Soundness Statutes*

The bill would rightly correct some glaring defects in the safety-and-soundness statutes governing the two GSEs. It would strengthen regulators' authority to prescribe capital standards and to take prompt corrective action or enforcement action. It would also fill a troublesome gap in current law by authorizing regulators to appoint a receiver for a critically undercapitalized GSE.

### *The GSEs' Double Game*

In dealing with their relationship to the federal government, Fannie and Freddie play an extraordinarily successful double game. They emphatically deny that they have any formal, legally enforceable government backing. In so doing, they leave the impression that they have no government backing at all. At the same time, they work to reinforce the market perception of implicit government backing (which all three statutory disclaimers of taxpayer liability fail to correct).

***Properly Comparing Banks and GSEs***

Fannie and Freddie wrongly argue that the federal government gives FDIC-insured banks benefits comparable to or greater than those it gives the two GSEs, and that the GSEs' success simply reflects their greater efficiency. Fannie and Freddie have lower overhead than banks because they do a different business than banks  a wholesale rather than a retail business. Moreover, contrary to what you might expect, the government's perceived implicit backing of Fannie and Freddie actually tends to provide a greater net subsidy than FDIC insurance, for six structural reasons: (1) unlimited coverage of all GSE obligations; (2) no receivership mechanism; (3) no cross-guarantees to protect the taxpayers; (4) company-specific statutes that avoid the discipline of having to comply with the same rules as thousands of other businesses; (5) protection from effective competition; and (6) not having to pay fees or to provide public benefits that would impose significant costs on the GSEs' shareholders.

***Systemic Risk***

Fannie and Freddie are often characterized as "too big to fail  meaning that the government would be forced to rescue them lest their failure unleash "systemic risk  that would harm the nation's financial system and economy. Yet there is nothing inevitable about such systemic risk; it results from human decisions. If investors expect the government to rescue troubled GSEs, investors will tend to let GSEs take greater risks than they otherwise would have taken. This weakening of market discipline on GSEs will, in turn, increase the risk that the GSEs ultimately will get into trouble. Thus "too big to fail  and "systemic risk  are to a large extent circular: they have their roots in prevailing expectations, and they easily become self-fulfilling prophecies.

But this circularity also has a positive side: by acting in a timely way, the government can correct "too big to fail  expectations. Congress did just that in the FDIC Improvement Act of 1991, which curtailed "too big to fail  treatment of banks.

***Opportunities for Immediate Administrative Action***

Regulators can and should act now to improve the regulation of Fannie and Freddie by (1) obtaining accurate data on FDIC-insured banks' investments in GSE securities, (2) limiting any excessive concentrations of GSE risk in banks' investment portfolios, (3) ending the mislabeling of mutual funds, (4) properly controlling the GSEs' daylight overdrafts, and (5) tightening scrutiny of the GSEs' mission.

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*The views expressed here are my own, and not necessarily those of Fordham University or Fordham University School of Law*

# STATEMENT OF RICHARD S. CARNELL

Mr. Chairman, Mr. Kanjorski, Members of the Subcommittee:

I am pleased to have this opportunity to discuss Fannie Mae, Freddie Mac, and H.R. 1409, the Secondary Mortgage Market Enterprises Regulatory Improvement Act.

As government-sponsored enterprises, Fannie and Freddie are privately owned, profit-oriented corporations that have Congressional charters and receive an array of federal benefits not available to businesses generally. More importantly, however, capital market participants believe that the government implicitly backs each GSE and would not let the GSE's creditors go unpaid. This perceived implicit guarantee is the GSEs' most important and most distinctive characteristic. It enables Fannie and Freddie to borrow over $1 trillion at rates below those available to even the most creditworthy fully private borrowers.

In my testimony today, I will:

(1) discuss the major provisions of H.R. 1409 including its choice of GSE regulator, its requirement that Fannie and Freddie comply with the securities laws, and its safety-and-soundness reforms and also suggest some additional provisions;

(2) describe the double game by which Fannie and Freddie deny that they have "full faith and credit government backing in ways that leave the impression that they have no government backing at all even as they work to reinforce the market perception of implicit government backing;

(3) analyze the GSEs' attempt to liken FDIC-insured banks to GSEs and to argue that we should not concern ourselves with GSE subsidies because the government gives banks greater subsidies;

(4) examine so-called "systemic risk particularly the argument that if a GSE got into financial trouble, the government would have no choice but to rescue it, lest its failure unacceptably damage the financial system;

(5) point to some opportunities for regulators to take immediate administrative action to improve the regulation of Fannie and Freddie; and

(6) identify nine important questions that Fannie and Freddie persistently manage to avoid answering.

**H.R. 1409**

The bill would take important steps to remedy weaknesses in current law. I believe that most of these changes merit enactment, with one major exception: rather than shifting GSE regulation to the Federal Reserve Board, I would keep the Office of Federal Housing Enterprise Oversight in existence and make it an autonomous bureau of the Treasury Department.

**Choice of Regulator**

Under the bill, the Federal Reserve Board would take over from OFHEO responsibility for the GSEs' safety and soundness, and take over from the secretary of Housing and Urban Development responsibility for the GSEs' housing mission.

In selecting an agency to regulate GSEs' safety and soundness, we should seek (1) competence, (2) resistance to special-interest pressure, and (3) no problematic conflicts of mission.

I support moving safety-and-soundness regulation out of HUD. Despite OFHEO's autonomy within HUD, having OFHEO part of HUD creates two types of problems. First, HUD  a wounded agency for decades  lacks both the will and the institutional credibility to stand up to the GSEs. Second, having OFHEO part of HUD encourages White House personnel officials to regard the directorship of OFHEO as a housing appointment rather than a safety-and-soundness appointment.

Although I believe that the Federal Reserve Board would capably regulate Fannie and Freddie, I have several concerns about transferring regulation to the Fed.

First, GSE regulation would potentially conflict with the Fed's responsibility for monetary policy. Managing interest-rate risk is a crucial part of Fannie and Freddie's business. What if good monetary policy called for a sharp and sustained increase in interest rates and yet such an increase would take a serious toll on the GSEs' safety and soundness? Such circumstances arose during the early 1980s, when high interest rates rendered Fannie market-value insolvent,[1] and they may arise again.[2]

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[1] U.S. Department of Housing and Urban Development, 1986 Report to Congress on the Federal National Mortgage Association 99-101 (1987).

[2] In designing the Thrift Savings Plan for Federal Employees, Congress may well have recognized the potential for a similar conflict of mission. Under the Senate bill, the chair of the Fed would also have

Second, having the Fed regulate Fannie and Freddie would potentially conflict with the Fed's role as lender of last resort through the "discount window. Such a regulatory relationship would tend to reinforce market participants' expectation that the government would rescue Fannie and Freddie if they ever got into trouble. Indeed, it might well be seen (however unfairly) as giving Fannie and Freddie a fast track to borrowing whatever sums they needed from the Fed, instead of having to face the delays and uncertainties of a legislative bailout. The Fed has authority to make emergency loans to any corporation, including Fannie and Freddie. 12 U.S.C. § 343.[3]

Third, the Fed would tend to be institutionally averse to facing down Fannie and Freddie, lest it risk a legislative rollback. The Fed's overriding institutional priority is to maintain its independence. Congress seldom has occasion to vote on what the Fed does, and the Fed tends to approach legislative battles warily. The potential for GSE-driven legislative setbacks would heighten the conflict between GSE regulation and monetary policy. For example, if a necessary but unpopular tightening of monetary policy had left the Fed politically isolated, the Fed would be reluctant to tighten GSE policy (e.g., safety-and-soundness standards) in ways that would risk conflict with Fannie and Freddie, even if tighter policy were appropriate.

Fourth, having the Fed regulate GSEs could create a potentially unhealthy concentration of power in a relatively unaccountable agency.

I recommend retaining OFHEO as Fannie and Freddie's safety-and-soundness regulator, making OFHEO an autonomous bureau of the Treasury Department, and assuring that OFHEO would in no way depend on the annual appropriation process.

**Registration and Reporting Under the Securities Laws**

Section 109 of the bill would rightly repeal the two GSEs' exemption from the registration and reporting requirements of the federal securities laws. It would thus require Fannie and Freddie to comply with the same public-disclosures rules as other large investor-owned corporations.

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chaired the Federal Retirement Thrift Investment Board; the House bill excluded the Fed from that board. Congress adopted the House approach. 5 U.S.C. § 8472; H.R. Conf. Rep. No. 99-606, at 138 (1986).

[3] Potential conflicts of mission already exist between the Fed's bank-regulatory responsibilities and its monetary-policy and discount-window responsibilities. But having the Fed regulate GSEs would add a new, untried function beset from the start by the longstanding expectation that the government would rescue any troubled GSE.

The GSEs' securities-law exemption has long been an anachronism. Fannie originated as a government corporation (as Ginnie Mae, the Tennessee Valley Authority, and the U.S. Postal Service still are). The federal government wholly owned and controlled Fannie, and Fannie sold investors only debt securities backed by the government's full faith and credit.[4] Thus exempting Fannie from securities registration and reporting requirements made sense. But that changed in 1968, when Fannie became an investor-owned company. Congress should have repealed Fannie's exemption then, and should not have given Freddie a similar exemption.

The exemption long ago lost any principled justification. It now sends exactly the wrong signal: that Fannie and Freddie are so "special, so close to the government, that investors in their securities have no need for the protections afforded by the registration and reporting requirements.

Fannie and Freddie seek to perpetuate that wrong signal. They argue that they already fully comply with those requirements. But if that is true, why do they so resist having the requirements apply? Would the Securities and Exchange Commission require fuller disclosure of the GSEs' risk exposure? Would the SEC conclude that the GSEs transgress generally accepted accounting principles? We do not know. But it is not enough for Fannie and Freddie to say that they comply. All large U.S. corporations say that they comply with the securities laws and with GAAP, and yet the SEC has occasion to disagree. Fannie and Freddie should undergo the same scrutiny.

**Correcting Defects in the 1992 Safety-and-Soundness Legislation**

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("1992 Act ) drew on banking law to strengthen the safety-and-soundness regulation of Fannie and Freddie. The 1992 Act required a new, more rigorous set of capital standards, and it included prompt corrective rules and new regulatory enforcement authority. But these provisions unwisely tended to deny OFHEO authority possessed by bank regulators. As a result, OFHEO has (in Tom Stanton's apt phrase) "a sort of parody of the authority of the federal bank regulators. H.R. 1409 would take important steps to correct these defects.

[4] According to the Department of Justice, "when Congress authorizes a federal agency or officer to incur obligations, those obligations are supported by the full faith and credit of the United States, unless the authorizing statute specifically provides otherwise. 6 Op. Ofc. Legal Counsel 262, 264 (1982).

### *Capital*

Bank regulators have broad authority to prescribe capital standards, including authority to impose new standards or toughen existing standards in light of experience. 12 U.S. Code §§ 1831o(c)(1), 3907(a). OFHEO, by contrast, faces major constraints on the form and content of capital standards. Id. §§ 4611-4612. Sections 112 and 113 of the bill would give the regulator some additional freedom to adjust the risk-based capital test. I would have concern about the potential for using section 112(3) to weaken the risk-based test, particularly if the regulator were part of HUD.

### *Prompt Corrective Action*

Prompt corrective action seeks to resolve financial institutions' problems before they give rise to large losses. The prompt corrective action rules governing Fannie and Freddie (12 U.S.C. §§ 4614-4619, 4622) are conspicuously weaker than the rules governing FDIC-insured depository institutions (id. § 1831o). For example, an undercapitalized bank cannot increase its total assets unless (1) the bank has an acceptable capital restoration plan, (2) the asset growth comports with the plan, and (3) the bank's capital ratio increases at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time (id. § 1831o(e)(3)). Yet no statute bars Fannie and Freddie from continuing to grow while undercapitalized, even if they have no capital restoration plan or if the growth conflicts with such a plan (id. § 4615). The prompt corrective action statute authorizes growth restrictions only against a significantly or critically undercapitalized GSE, and makes such sanctions purely discretionary (id. §§ 4616(b)(2), 4617(b), (c)(2)). Sections 131 through-133 of the bill would corrective some of the most conspicuous weaknesses of the current GSE prompt corrective action statute.

### *Enforcement*

OFHEO's authority to take enforcement action against Fannie and Freddie (id. §§ 4631-4636) is conspicuously weaker than that of its banking agency counterparts (id. § 1818). Sections 151-156 of the bill would take appropriate steps to strengthen enforcement authority over GSEs.

### *Receivership*

Bank receivership laws facilitate rapid, efficient, and orderly resolution of claims against a failed or failing bank. The FDIC can take control of the bank, give insured depositors ready access to their money, and preserve any going-concern value. But no comparable receivership mechanism exists for Fannie and Freddie. Neither OFHEO nor anyone else has statutory authority to appoint a receiver. OFHEO can appoint only a *conservator*, which generally has the powers of a GSE's shareholders, directors, and officers (id. § 4620(a)). But these powers do not include requiring a GSE's creditors to accept less than 100 cents on the dollar or to swap debt for equity. Thus, for example, if a GSE's assets were worth less than its liabilities, a conservator could not resolve the insolvency, and pressure for a taxpayer bailout would mount.

Section 134 would remedy this defect in current law by authorizing the GSE regulator to appoint a receiver for a critically undercapitalized GSE. This would avoid troublesome uncertainty about how to deal with such a GSE.

**Recommendations for Additional Legislative Action**

I suggest that H.R. 1409 include several additional provisions.

First, the bill should correct the faulty statutory disclaimers of federal liability for Fannie and Freddie (discussed below in the section entitled "The GSEs' Double Game ).

Second, the bill should correct sloppy language in the Secondary Mortgage Market Enhancement Act of 1984 stating that for some purposes Fannie and Freddie securities "shall be considered to be obligations issued by the United States. 15 U.S. Code. § 77r-1(a)(1)-(2).

Third, the bill should prohibit any GSE from representing that the government directly or indirectly backs the GSE (except in discussing formal, legally enforceable obligations of the government) with the intent to induce anyone to rely on that representation in connection with the purchase or sale of any security.

Fourth, the bill should clarify that the GSEs must limit their activities to the secondary mortgage markets.

## THE GSEs' DOUBLE GAME

**In General**

In dealing with their relationship to the federal government, Fannie and Freddie play an extraordinarily successful double game: they deny that they have any formal, legally enforceable government backing, even as they work to reinforce the market perception of *implicit* government backing. Let's look more closely at the two parts of the double game.

First, Fannie and Freddie emphatically deny that they have any formal, legally enforceable government backing in itself, a valid point. But the GSEs make this point in ways designed to convince the uninitiated that the GSEs enjoy *no government backing at all* (an implication directly conflicting with the second part of the double game). The GSEs stress that "Every one of our debt securities clearly states, in plain English, it is not backed by the full faith and credit of the government.[5] They argue that they operate "with entirely private capital and that their activities "are entirely supported by [their] revenue . . . and the capital of private investors and are *not in any way guaranteed by the federal government.*[6]

Second, Fannie and Freddie work to reinforce the perception of implicit government backing. Consider three examples involving Fannie. First, Fannie sought legislative history stating that Fannie and Freddie "are *implicitly backed by the full faith and credit of the U.S. Government.*[7] Second, Fannie attacked Treasury Under Secretary Gensler as "irresponsible and "unprofessional when he testified before this Subcommittee on March 22, 2000, that "the government does not guarantee [GSEs'] securities.

Third, in a 1998 letter to the Office of the Comptroller of the Currency, Fannie argued that "all GSE issued securities merit more favorable treatment under the federal banking agencies' risk-based capital standards than all "AAA-rated [non-GSE] asset-backed securities. Thus the mere fact that a GSE issues a security makes that security more creditworthy than any non-GSE security. An IOU issued by a financially troubled GSE (such as the Farm Credit System before its 1987 bailout) would, under Fannie's reasoning, still be more creditworthy than a top-tier asset-backed security guaranteed by the nation's healthiest fully private corporation. Fannie based this argument squarely on what it calls "the implied government backing of Fannie Mae :

> GSE issues generically, and Fannie Mae-guaranteed MBS in particular, are viewed by the capital markets as *near proxies for Treasury securities* in terms of credit worthiness.

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[5] Franklin D. Raines, Remarks at Conference on Money Markets and the News: Press Coverage of the Modern Revolution in Financial Services, March 19, 1999.

[6] Fannie Mae, FM Watch Observer: Glossary of Terms, www.fmwatch-observer.com/glossary.html (emphasis added).

[7] When I worked for the Senate Banking Committee on a Glass-Steagall repeal bill in 1987-88, Fannie asked that I include such language (emphasis added) in the section-by-section analysis, which I declined to do.

> . . .
> Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and the rating agencies view the *implied government backing of Fannie Mae* as a sufficient indication of the investment quality of Fannie Mae obligations. . . .[8]

Thus Fannie contended that in assessing credit quality, investors and rating agencies do not (and presumably need not) look beyond "the implied government backing of Fannie Mae, which in Fannie's view renders Fannie's securities "near proxies for Treasuries. These assertions are all the more remarkable in that Fannie made them in a formal comment letter to a bureau of the Treasury Department. We may reasonably infer that when Fannie meets with rating agencies and securities analysts out of earshot of government officials it makes arguments at least as strong as those quoted above.

The double game is objectionable insofar as the GSEs imply, or even expressly assert, that they enjoy no federal backing at all which directly conflicts with the GSEs' simultaneous efforts to stoke the market perception of implicit federal backing. No one argues that the government has any formal, legally enforceable liability for the GSEs' securities. The real issue is whether the government would nonetheless rescue the GSEs for example, because public officials believed that default by the GSEs would unacceptably harm the nation's financial system.

**Ineffective Statutory Disclaimers**

In seeking to limit the taxpayers' exposure to the GSEs, Congress has enacted three disclaimers of liability. But the phrasing of these disclaimers, far from hindering the GSEs' double game, fits it neatly.

First, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act ) declares that "neither the [two] enterprises . . . , nor any securities or obligations issued by the enterprises . . . , are backed by the full faith and credit of the United States. 12 U.S.C. § 4501(4). But this disclaimer merely restates the obvious: that the government has no formal, legally enforceable liability for the GSEs' securities. It does not disclaim implicit backing, nor does it signal that market participants err in perceiving such backing. It thus avoids the real issue.

Second, a statutory section entitled "Protection of taxpayers against liability declares that the 1992 Act "may not be construed as obligating the Federal Government,

[8] Letter from Anthony F. Marra to OCC, Feb. 3, 1998 (emphasis added).

either directly or indirectly, to provide any funds to Fannie or Freddie "or to honor, reimburse, or otherwise guarantee any obligation or liability of Fannie or Freddie. Id. § 4503. This disclaimer also avoids the real issue. No one argues (so far as I am aware) that the 1992 Act *created* implicit backing where it did not already exist. Market participants had long believed such backing to exist under the GSEs' charters. Congress did not act to correct that perception.[9]

Third, each firm's securities must include "appropriate language . . . clearly indicating that the securities "are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the GSE in question. Id. §§ 1455(h)(1), 1719(b), (d)-(e). This requirement repeats the fundamental weakness of the first disclaimer: it disclaims formal, legally enforceable liability (which is not the issue), even as it fails to disclaim implicit backing (which is). "Indeed, the disclaimer itself hints at a special federal relationship; completely private firms do not need to disclaim federal backing because no one believes such backing exists. [10]

**Subsidy Denial**

The GSEs' double game helps the GSEs argue that they get little or no government subsidy. Yet no one can honestly dispute that Fannie and Freddie receive valuable benefits not available to businesses generally. These benefits include exemption from most state and local taxes and exemption from the registration and reporting requirements of the securities laws. The benefits also include a line of credit at the U.S. Treasury and special rules relating to the GSEs' securities for example, rules that: equate those securities with U.S. Treasury securities for some purposes; permit issuance and transfer of those securities over the system used for issuing and transferring U.S. Treasury securities; and fail to limit FDIC-insured banks' investments in those securities. This special treatment strongly abets the market perception of implicit federal backing. The recent Congressional Budget Office report demonstrates the great value of these special benefits.

Yet Fannie, in particular, insists that it receives no subsidy. Relying on a narrow dictionary definition to the effect that a "subsidy is "monetary assistance granted by a

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[9] The second disclaimer also replicates the weakness of the first disclaimer in declaring that the 1992 Act "may not be construed as implying that any such enterprise . . . , or any obligations or securities of such an enterprise . . . , are backed by the full faith and credit of the United States. Id. § 4503.

[10] Ronald C. Moe & Thomas H. Stanton, *Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 323 (1989).

government to a person or private commercial enterprise, Fannie asserts: "Fannie Mae does not receive a penny of public funds. To the contrary, last year our federal tax liability was $1.6 billion. True subsidies also are tangible. Fannie Mae's government benefits are not.[11] Fannie's reasoning that a subsidy involves only a tangible payment of money by the government produces absurd results. If Congress were to exempt Fannie from ever again having to pay any corporate income tax, that would supposedly not be a subsidy because it would involve no cash payment to Fannie. Similarly, if a foreign government gave an energy-intensive, capital-intensive export industry unlimited access to free electricity and low-cost government-guaranteed loans, that would supposedly not be a subsidy, either. These examples highlight the unreality of Fannie's arguments.

Subsidy-denial has provided cover for a vast outpouring of GSE debt even as the nation has made real progress towards getting its fiscal house in order. From FY 1992 to FY 2000, the federal budget went from a $290 billion deficit to a $236 billion surplus. But over that same period the three housing GSEs' net outstanding debt securities rose from $0.3 trillion on December 31, 1992, to $1.7 trillion on December 31, 2000, and their net outstanding mortgage backed securities rose from $0.8 trillion to $1.3 trillion. Thus the GSEs had $2.5 trillion in net outstanding obligations compared with a privately held marketable Treasury debt of $2.5 trillion.

## PROPERLY COMPARING BANKS AND GSEs

Fannie and Freddie often argue that the federal government gives FDIC-insured banks[12] benefits comparable to, or even greater than, those it gives Fannie and Freddie; that concern about subsidies to Fannie and Freddie is accordingly unwarranted and even hypocritical; and that any greater financial success shown by Fannie and Freddie simply reflects their greater efficiency.

Let's start with the issue of efficiency. Fannie and Freddie have lower overhead than banks because they do a different business than banks. Most banks do a predominantly retail business. To deal directly with large numbers of small customers, they have more offices and larger staffs than they otherwise would. By contrast, Fannie and Freddie do a wholesale business, which enables them to have lower overhead.

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[11] Timothy Howard, Fannie Mae's Benefits to Home Buyers: The Business Perspective, Remarks to Federal Reserve Bank of Chicago Annual Conference on Bank Structure and Competition, May 11, 2001.

[12] For simplicity I use "banks to refer to all FDIC-insured depository institutions, including thrift institutions.

Now let's turn to the issue of relative subsidy. FDIC insurance has a different set of costs and benefits than the government's sponsorship of Fannie and Freddie. You might expect FDIC insurance to provide a greater net subsidy.[13] After all, FDIC insurance is established by law and carries the government's full faith and credit. Yet the government's perceived implicit backing of Fannie and Freddie actually tends to provide a greater net subsidy than FDIC insurance, for six structural reasons.[14]

***1. Unlimited Coverage.*** Federal deposit insurance applies only to deposits and then only up to a $100,000 limit. The FDIC can protect a failed bank's uninsured deposits and nondeposit creditors (such as bondholders) only under very narrow circumstances. By contrast, the government's perceived implicit backing of GSEs has no limits: it applies to all of a GSE's obligations, with no dollar ceiling.

***2. No Receivership Mechanism.*** When an FDIC-insured bank fails, the FDIC becomes *receiver* for the bank: it takes control of the bank, gathers the bank's assets, and pays the bank's creditors in a specified order of priority. The bank's depositors must get paid in full before the bank's other creditors can get paid at all. If the bank's liabilities exceed its assets, its shareholders lose their ownership interest, its nondeposit creditors normally incur a partial or total loss, and its uninsured depositors often incur some loss. Similarly, when an ordinary nonfinancial company fails, it is liquidated under chapter 7 of the Bankruptcy Code. The bankruptcy court appoints a trustee, who takes control of the company, gathers its assets, and pays creditors in a specified order of priority.

No credible, workable receivership mechanism exists for Fannie and Freddie. Their charters do not provide for receivership, nor does the 1992 Act. The Bankruptcy Code does not permit Fannie or Freddie to become a debtor in a bankruptcy proceeding.[15] The lack of a receivership mechanism reinforces the market perception that the government would assure full payment of Fannie and Freddie's creditors.

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[13] The gross subsidy represents the total value of the special benefits provided by the federal government benefits not available to businesses generally or even financial institutions generally. The net subsidy represents the difference between the gross subsidy and the offsetting costs that the entity must incur as a bank or GSE costs not imposed on financial institutions generally.

[14] I have set forth these arguments more fully in *The Structure of Subsidy: Federal Deposit Insurance Versus Federal Sponsorship of Fannie Mae and Freddie Mac*, to published as chapter 4 of SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC (forthcoming 2001).

[15] As federal instrumentalities, Fannie and Freddie are "governmental units under § 101(27) of the Bankruptcy Code and thus under § 101(41) are not a "person. Under § 109(a) only a "person can become a "debtor in a bankruptcy proceeding. See 11 U.S.C. §§ 101(27), (41), 109(a).

***3. No Cross-Guarantees to Protect Taxpayers.*** Federal deposit insurance involves strong safeguards designed to ensure that banks rather than the taxpayers bear any losses incurred in protecting insured depositors. Banks must normally pay premiums large enough to ensure that the FDIC's insurance funds have at least $1.25 in reserves for each $100 of insured deposits. This obligation to pay premiums gives each insurance fund a claim on the capital and earnings of all banks insured by that fund and in effect creates a network of indirect *cross-guarantees* among FDIC-insured banks. Thus each member of the Bank Insurance Fund is liable for ensuring that the FDIC can protect insured depositors at every other BIF member bank. As long as the fund can replenish its reserves, its existence precludes any loss to the taxpayers.

No similar cross-guarantees reduce the government's risk-exposure to Fannie and Freddie. The two GSEs pay no insurance premiums and have no insurance fund. The two GSEs do not even cross-guarantee each other. If one GSE were to fail, the survivor would have no responsibility to pay the failed GSE's creditors.

***4. Special Deals Instead of General Rules.*** To a much larger degree than banks, Fannie and Freddie reap the benefits of special, company-specific laws and avoid the discipline of generic law. Instead of operating under laws applicable to thousands of businesses, the two GSEs often get to operate under statutes designed for them alone.

***5. Protection from Effective Competition Subsidizes GSE Shareholders.*** Federal and state regulators routinely issue bank charters to qualified applicants. Once chartered, a bank can typically engage in a wide range of activities statewide and even nationwide. Gone are the days when each bank charter required special legislation. Gone are the days when regulators would grant charters sparingly so as to limit competition with existing banks. Entry into banking is relatively easy, and banking law affords banks little protection against competition. Thus if banks receive a net federal subsidy, they should generally face enough competition to force them to pass the subsidy through to their customers.

Fannie and Freddie, by contrast, enjoy significant protection against competition. Their government sponsorship reduces their borrowing costs and increases the value of their guarantees to such an extent that no fully private firm can compete against them effectively. And only Congress can charter a competing GSE. By impeding competition with Fannie and Freddie, these constraints on entry increase the potential for the two GSEs' government benefits to end up in the hands of their shareholders rather than their customers.

***6. Free Ride.*** Banks must normally pay for deposit insurance. They must also comply with an array of restrictions and requirements not applicable to businesses generally. But Fannie and Freddie pay no fee for their government sponsorship. They make no payments to an insurance fund or affordable housing fund. They need not provide public benefits that impose significant costs on their shareholders. HUD's affordable housing goals are so weak that Fannie and Freddie can meet them without doing more for affordable housing than banks do. I believe that the two GSEs would have a profit motive to do their affordable housing business in any event, even without a government subsidy.[16]

Considering the great value of the benefits Fannie and Freddie receive from the government, they should be doing *far* more to increase home ownership at the margin (e.g., by the lower middle class, the working poor, and members of certain minority groups).

**SYSTEMIC RISK**

Fannie and Freddie are often characterized as "too big to fail meaning that if they were in danger of default, the government would have to rescue them lest their failure unleash "systemic risk that would gravely damage the nation's financial system and economy.

Discussions of systemic risk (whether in the GSE or the bank context) often have a tone of inevitability. But systemic risk is not a force of nature like earthquakes, hurricanes, and tornados. It results from human decisions: for example, decisions by market participants and government officials about how to structure the financial system,

[16] Fannie and Freddie have provided no detailed disclosure of the profitability of their affordable housing programs. When the Treasury asked them for such information in 1996 for use in a Congressionally mandated study, Fannie and Freddie responded very differently. Freddie replied that it "purchases most single-family and multifamily mortgages in support of affordable housing through its standard mortgage purchase programs and under the same credit standards as its other mortgage purchases. One can reasonably infer that affordable housing goals did not impose significant costs on Freddie's shareholders: if "most affordable housing loans met Freddie's usual credit standards, then they presumably also provided something approximating a normal return.

Fannie called the information proprietary and refused to provide it unless the Treasury signed a written agreement constraining the Treasury from making public use of the information, which would have defeated the purpose of obtaining the information. One can reasonably infer that Fannie withheld the information because it indicated that Fannie's affordable housing programs were quite profitable.

Toward the end of this statement, I suggest three questions to shed light on the profitability of Fannie and Freddie's affordable housing activities and thus on the GSEs' incentives to continue those activities even without government sponsorship ("Questions for Fannie and Freddie, questions 7-9).

what risks to take, and how to respond to problems. If investors expect the government to protect them from the full pain of downside scenarios, they will tend to take greater risks than they otherwise would have taken. Thus "too big to fail and "systemic risk are to a large extent *circular*: they have their roots in prevailing expectations, and they easily become self-fulfilling prophecies. Insofar as investors expect the government to rescue troubled GSEs, market discipline on GSEs will weaken, which will tend to increase the risk that the GSEs ultimately will get into financial trouble.

If a GSE's troubles coincide with a broader financial crisis, government officials will face additional pressures to rescue the GSE. For if during the crisis those officials seriously upset established expectations, they may create contagious uncertainty about the government's willingness to meet other expectations. A crisis is thus a particularly inopportune time for attempting to reeducate market participants about the scope of the government's undertakings. So if the government tacitly accepts "too big to fail expectations during good times, it may find itself constrained during a crisis to rescue a GSE against its better judgment.

But the circularity of systemic risk also has a positive side: if the government acts in a timely way, it can correct "too big to fail expectations. Congress did just that in the FDIC Improvement Act of 1991 ("FDICIA ) by curtailing the practice of treating FDIC-insured banks as "too big to fail. [17] FDICIA's "least-cost resolution rule allows the FDIC to protect a failed bank's uninsured depositors and nondeposit creditors only if doing so is the "least costly to the deposit insurance fund of all possible methods for meeting the FDIC's obligation to insured depositors. 12 U.S.C. § 1823(c)(4). The rule has a narrow systemic-risk exception, which has never been used.[18] Before FDICIA, the FDIC was spending extra money from the deposit insurance fund to protect uninsured

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[17] In context of a failed FDIC-insured bank, "too big to fail treatment involves spending extra money from the deposit insurance fund to protect deposits above the $100,000 limit on deposit insurance coverage. It may also involve extra spending to protect nondeposit creditors.

[18] The systemic-risk exception becomes an option only if recommended to the secretary of the Treasury by two-thirds majorities of both the Federal Reserve Board and the FDIC's Board of Directors. The secretary can make the exception only if the secretary determines, "in consultation with the President, that least-cost resolution of a given institution "would have serious adverse effects on economic conditions or financial stability. The secretary must document the determination. The General Accounting Office must review and report on the exception, including the potential for it to diminish market discipline and encourage unsound risk-taking. To recoup the additional cost of deviating from least-cost resolution, the FDIC must levy a special assessment on insured depository institutions. Id. § 1823(c)(4)(G). Congress designed these rules to promote accountability and make the process sufficiently unpleasant that systemic-risk exceptions would be made rarely (if at all) and never lightly.

depositors at banks as small as $500 million in total assets. But less than one year later, when an $8.8 billion bank group in a swing state failed on the eve of the 1992 Presidential election, the FDIC did *not* protect uninsured depositors.[19] Financial markets took this action in stride. By giving clear and timely notice of the new policy, Congress had succeeded in changing market participants' expectations.

## OPPORTUNITIES FOR IMMEDIATE ADMINISTRATIVE ACTION

Regulators can and should act now to improve the regulation of Fannie and Freddie.

First, bank regulators should use their existing data-gathering authority to obtain accurate data on FDIC-insured banks' holdings of GSE securities. They should correct call-report forms so as to distinguish between GSEs and true government agencies like Ginnie Mae.

Second, if FDIC-insured banks do have problematic concentrations of risk in GSE securities, bank regulators should take corrective action now, again using their existing authority. Although 12 U.S.C. § 24(Seventh) exempts GSE securities from its own 10-percent-of-capital limit on holding securities of one issuer; it does not impair regulators' other authority to act against problematic concentrations of credit risk (e.g., through rulemaking in the spirit of section 305(b)(1)(A)(ii) of FDICIA, which calls for risk-based capital standards to "take adequate account of . . . concentration of credit risk ), or through enforcement action under 12 U.S.C. § 1818).

Third, the SEC should prohibit mutual funds whose portfolios consist in large part of GSE securities from mislabeling themselves as "Government or "U.S. Treasury funds.

Fourth, the Fed should review the adequacy of its current safeguards on so-called "daylight overdrafts by GSEs.

Fifth, HUD should tighten its scrutiny of the GSEs' mission, using its authority to review activity-expansion, prescribe affordable-housing goals, and interpret relevant statutes.

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[19] The First City Banks of Texas failed on October 30, 1992. Uninsured depositors ultimately suffered no loss but only because the banks' assets ended up being worth more than their liabilities. In the Presidential election four days later, President Bush received 40.6% of the vote in Texas, Governor Clinton 37.1%, and H. Ross Perot 22.0%.

## QUESTIONS FOR FANNIE AND FREDDIE

Over the years, Fannie and Freddie have had remarkable success in dodging inconvenient questions about their relationship with the federal government and about their affordable housing programs, such as the following:

1. If the federal government does not subsidize Fannie and Freddie, why exactly do Fannie and Freddie object to giving up their various ties to the government?

2. Do capital market participants *err* in perceiving the federal government as implicitly backing Fannie and Freddie?

3. Do *you* believe that the federal government in any way implicitly backs Fannie and Freddie?

4. If Fannie and Freddie were to default on their obligations, would the federal government have any *moral obligation* to assure that Fannie and Freddie's creditors got paid?

5. If Fannie or Freddie were to get into serious financial trouble, would anything prevent the government from letting that GSE's creditors incur a loss?

6. What, if anything, would be wrong with Congress enacting legislation making clear that Fannie and Freddie must confine their activities to the secondary mortgage market?

7. Of all loans purchased by Fannie and Freddie, what percentage consists of affordable housing loans that provide more flexible underwriting standards (e.g., that allow borrowers to have higher debt or income ratios or make lower down payments; for brevity, "special affordable housing loans )?

8. Of all loans purchased by Fannie and Freddie that count toward the Department of Housing and Urban Development's affordable housing goals, what percentage consists of special affordable housing loans?

9. Of all loans purchased by Fannie and Freddie, how does the profitability (i.e., overall rate of return) of special affordable housing loans compare with the profitability of other loans that count toward HUD's affordable housing goals and with the profitability of loans that do not count toward those goals?

I recommend that you ask Fannie and Freddie to answer questions 1 through 6 fully, clearly, and unequivocally. I also recommend that you ask the General Accounting Office to study questions 7 through 9 for the period from January 1, 1993, to the present.

## CONCLUSION

Mr. Chairman, you have taken on an admirable but unenviable challenge: seeking to fix problems before the crisis hits or the scandal breaks. Your bill would make significant improvements in the regulation of Fannie and Freddie. More broadly, the bill and this hearing are important in continuing to focus the spotlight on the GSEs, their valuable government benefits, and the question whether they give the American people a return commensurate with those benefits.